

ABSTRACT

Some Current Issues of International Monetary Policy

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This paper addresses some current policy issues relating to international monetary arrangements. There is first a discussion of some questions relating to the International Monetary Fund, including its role as a possible lender of last resort to prevent future international financial contagion. Some arguments relating to Britain's possible entry into the euro system are also raised, with principal attention to Britain's transactions with the non-euro countries. Some issues of exchange rate policy, including currency unions, for countries outside the euro area and the United States are also discussed.

SOME CURRENT ISSUES OF INTERNATIONAL MONETARY POLICY

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Section 1

Introduction

The international financial difficulties associated with the Asian problems of 1997-9 focused attention on international monetary arrangements such as the role of the International Monetary Fund, and the types of exchange rate regime (fixed, floating, or something in between) employed by a number of countries that suffered serious difficulties during the Asian crisis. In addition, the setting up of the euro system in Europe and the debate on whether the EU countries outside it – especially Britain – should become members have important implications not only for the countries concerned, but also indirectly for countries outside those arrangements. Membership of the euro system does not involve merely a choice of exchange rate regime for the member countries of the euro system, but also involves them in certain undertakings relating to their fiscal policies, in addition to the implications for their monetary policy of membership of the euro system. What happens in Europe is clearly of importance to the world economy as a whole, and so also to non-European countries, especially to those that are linked closely to Europe by ties of trade and investment.

It therefore seems appropriate to consider some important aspects of future international monetary arrangements, and, in particular, the implications for the rest of the world of arrangements by groups of countries. Section 2 discusses certain aspects of the future of the International Monetary Fund. Section 3 looks at some aspects of the question of whether Britain should enter the euro, and some implications for the non-European world if it should do so. (There are also some implications for other suggested currency unions.) Section 4 brings together a number of issues of exchange rate policy, including those that relate to groups of countries. Section 5 discusses some aspects of monetary and fiscal policy in the context of exchange rate arrangements. A concluding section summarises the main ideas and mentions some of the interactions among these various issues.

Section 2

The Future of the International Monetary Fund

All members of the Fund clearly have an interest in any major changes in the International Monetary Fund Charter. Recent discussions about the future of the Fund arose partly because of widespread unease about the IMF's approach to the problems of a number of Asian countries, and the view that conditions imposed on them were too harsh. There have, on the other hand, been fears that the assistance rendered by the Fund to some of these countries, enabling them to meet the demands of some overseas investors lending to those countries, were producing a situation of moral hazard in two ways. The first was by tending to increase the likelihood of investors taking insufficient care in future in lending to such countries. The second risk was of borrowing countries borrowing too rashly again in future, in the expectation of the Fund again providing assistance if the borrowing countries fell into serious difficulties.

If the conditions imposed by the IMF for providing assistance to some of the Asian countries during their crisis were too harsh, the appropriate remedy is obviously to learn from the experience of that period, by imposing more appropriate conditions in future¹. Indeed, there is some reason to believe that the IMF itself would probably take a somewhat different approach in future, by way of ensuring that undue pressure to deflate is not imposed on countries as a condition of drawings from the Fund.² So long as circumstances may arise where IMF assistance is considered desirable, amendment of the sort of conditions attached to drawings is obviously the right remedy, rather than a cessation of the IMF's role as provider of temporary finance.

An extreme position taken by some observers is that the IMF should be abolished, because of the moral hazard produced by the availability of funds from it; or, at least, that there should be a new Bretton Woods – a complete overhaul of the IMF Charter (presumably along with that of the World Bank). The problems of moral hazard, operating through both lenders and borrowers, are real and probably inevitable to some extent, as is true also whenever a central bank is known to be willing to step in to provide assistance to banks in some circumstances. But there is a clear role for an institution such as the IMF. For the central bank of a country suffering from a temporary crisis of confidence on the part of external investors may not have the resources of foreign exchange with which to allay the panic. At the very least, there is a strong case for the IMF (or some successor organisation)

¹ See, for example, Stiglitz (1999) and (2000). *The Economist* (April 15th 2000) has criticised this view, on the argument that the Asian countries in question recovered sharply between 1998 and 2000. But this recovery did not make up for the loss of potential output and employment in those countries in 1998 and 1999.

² The IMF's Acting Managing Director, Stanley Fischer, has acknowledged (in a conference in April 2000) that too tight a fiscal policy was imposed on some of these countries, but believed that the

being able to step in to prevent 'contagion'. This is when a lapse of confidence in one currency (which may be fully justified) leads to lapses of confidence in the currencies of other countries, which may arise merely because investors draw a false analogy between the situations of a country that comes under pressure initially and that of other countries.

Incidentally, this sort of situation may arise in any country or group of countries, and not only among developing countries, to which IMF drawings seem to have become confined over the past quarter-century or so. It is true that close coordination among central banks of developed countries may be able to deal with such problems, but reaching agreement among them may well take more time, and be more limited, than intervention by the IMF might be, assuming that it had enough resources available for effective intervention.

It is, in any event, crucial that there should be available adequate liquidity to quickly restore confidence in the currencies of the countries that have been affected by the contagion. Indeed, if panic is to be allayed and contagion avoided it is essential that the resources available for this purpose should be known to be essentially unlimited. (As Bagehot put it in discussing the proper role for the Bank of England in the nineteenth century, in a crisis 'the Bank must be willing to lend without stint'.) But would the members of the IMF be willing to make available essentially unlimited resources for it to use at its discretion in order to allay or avoid panic and contagion?

It appears that the new European central bank does not at present intend to play this role of lender of last resort. But there is a real danger that financial panics may arise involving several European countries simultaneously. (See McKinnon and Pill, (1999).) If that does occur, either the ECB should be given the task and resources to step in; or, failing that, the IMF should be placed in a position where it could do so. That would necessitate a reversion from the assumption that IMF drawings are available only to developing countries, and the acceptance of the view that it may be in the interests of all members that IMF resources shall sometimes be made available to prevent contagion among developed countries. (The New Arrangements to Borrow among major countries would presumably be available to deal with this problem; but those resources might well be inadequate to deal with a serious crisis of confidence in a major currency.) The IMF has been trying to find ways to 'bail in' external investors to roll over their loans (in the investors' currencies) in the event of the borrowing country falling into serious difficulties³ Perhaps the resources available to the IMF

monetary measures imposed were not too tight. But, surely, the basic criticism was that the overall downward pressure imposed on activity in those countries was too great.

³ Buiter and Sibert (1999) have suggested that it should be made mandatory for countries raising debt fixed in terms of external currencies to have attached to such loans an automatic right for the loans to be rolled over on a declaration by some body such as the IMF that disorderly conditions, subjecting them to a flight of capital, have arisen, risking the spread of contagion to other countries. This would of course

for this purpose should be increased, but segregated from its other resources and available only for the prevention of contagion.

As to assistance from the IMF to individual countries suffering supposedly temporary balance of payments problems, the principle should surely be to impose conditions that do not lead to a reduction in their total output or employment. The adoption of that principle would contrast with the conditions imposed on several Asian countries during the 1997-9 crisis. If the level of demand there is already clearly excessive, however, one condition of the drawing should of course be that the excess be removed. But reductions in real output should not be insisted upon merely with the aim of strengthening the balance of payments. At the same time, the conditions for making available such finance must ensure that its availability does not lead to the drawing countries pursuing inflationary policies.

A view put to the US Congress by a Committee headed by Alan Meltzer (2000)(with which the US Secretary of the Treasury is said to sympathise) is that the IMF's role should be largely confined to dealing with crisis situations – as lender of last resort – and that it should no longer finance short-term balance of payments problems (except in certain limited circumstances), still less act as a source of long-term aid (which it has in effect become in recent years). There is much to be said for the view that decisions about the provision of aid should not be made as an indirect (and often unintended) result of decisions about drawings on the IMF. But it is understandable that developing countries – and probably other countries also – would want there to be provision for correspondingly higher levels of aid to be provided through other sources if the IMF's resources were no longer to be used for purposes as long term as some of them have been recently. Moreover, if the IMF's role were known to be to act mainly or solely in situations of crisis it would tend to increase the risk and scale of crisis whenever the IMF acted, especially if the resources available to the Fund to deal with a crisis were known to be limited. Furthermore, the interest rates charged on that accommodation (especially if, as has been suggested by the Meltzer committee, it were at a penal rate) to the borrowing country might well make it unwilling to accept that burden. This would make it harder to reduce the risk of contagion. As such a policy would be in the general interest of the world economy as a whole, it would

mean that lenders would insist on an increase in the interest rate paid on such borrowing, to cover the risk of such a situation of compulsory rollover being imposed. It is true that would reduce the extent of such borrowing: and, indeed, that would be one of the main purposes of it. But, clearly, such an arrangement would be unenforceable if the borrowing countries did not want it, and they might still prefer to run the risk of rapid withdrawal of capital without such an automatic arrangement for rolling over their external borrowing, and the consequently higher cost of the loans. Nor would the countries most susceptible to such capital flights – or most likely to induce contagion – necessarily be the countries that would be willing to adhere to such a scheme. Most financially sophisticated countries might well be unwilling to participate in it: although they too may be sources of contagion.

in any event be inappropriate to impose a high proportion of the cost on the country where the problem started..

An approach that would be fully consistent with one of the original aims of the IMF would be for it to (continue to) provide finance to avoid some changes in exchange rates that temporary problems would otherwise necessitate, if exchange rate changes would not be required in the light of the 'fundamental' (or 'long-term') situation of the country. But this assumes that, for some countries at least, a degree of exchange rate fixity (in some sense), or at least some limits to the amount of exchange rate fluctuations, is the normally desirable situation. We return to aspects of this in Section 3.

Section 2

Britain, Euroland and Non-Euroland

In the course of making a case for Britain's entry to the euro system, (1999 a), (1999 b), (1999 c) – and also in considering the case for Canada to enter a currency union with the US (1999 d) - Buitter has argued that traditional optimum currency area analysis, dating as it does from the 1960s when capital flows were much less free than they are now, fails to take due account of the current freedom of international capital flows. He argues that the present situation is such that the world as a whole really represents an optimum currency area. For (he argues) the issues relating to trade and output that characterised the accepted optimum currency area analysis of the past are much less relevant than those relating to the flow of capital between countries. He argues that the asymmetric shocks analysis of the accepted optimum currency area literature (originating with Mundell (1961)) is not convincing as an argument for Britain to stay out of the euro system, as (in his view) Britain is susceptible to much the same sorts of shocks as are the present members of Euroland. In any case, he believes that the degree of rigidity of nominal prices and wages that is necessary for the use of monetary policy operating through the exchange rate as a means of affecting real variables is not present in anything but the short run (for Britain at any rate).

One may accept most of what he says on these points, however, without its constituting a convincing case for Britain to enter the euro. A fix of sterling against the euro (which is the aspect of Britain entering the euro that seems to appeal to many businesses in the UK) is not in fact a fixed exchange rate for sterling. For the greater the degree of exchange rate fixity of sterling against the euro, the greater the degree of fluctuation of sterling against non-euro currencies.⁴ Indeed, this would not even constitute greater stability of sterling 'on

⁴ It should be self-evident that a greater degree of fixity of sterling against the euro *means* a greater degree of volatility of sterling as against non-euro currencies. Indeed, that statement amounts to a tautology. But if it requires spelling out (and the widespread neglect of it seems to imply that it does), consider a situation where the euro appreciates by, say 1% against non-euro currencies. If Britain is in the euro

the average' in some sense. For even though Britain's visible trade transactions with the Euroland countries are quantitatively somewhat larger than those with the rest of the world, the opposite is true (on the available evidence), though only marginally so, if invisibles, but *a fortiori* if capital flows, are brought into the discussion.⁵ If the objective is exchange rate certainty and transparency of prices (of capital assets as well as prices of goods and services), due emphasis upon Britain's transactions with the non-euro world greatly weakens Buiter's argument for sterling to be fixed against the euro, and probably reverses it. But stability of Britain's exchange rate vis-à-vis the outside world as a whole requires that sterling should be stable on an average of external currencies, and not on one of them alone. The relative size of transactions with the two different areas is relevant only if there is a case for fixing on one or the other – and that would be convincing on this score only if transactions with one of the two areas were much more dominant relative to those with the other than is true in Britain's case. For a country such as Britain, for which transactions with the euro area are broadly comparable in size to those with the rest of the world, there is not a convincing argument for Britain to fix its currency on either area if the aim is transparency of prices and exchange rate certainty.⁶

Moreover, it does not appear to increase the force of the case for Britain's entry to argue that the relative importance of transactions with Europe would increase after Britain entered Euroland. For, if that in fact occurred, the costs (to Britain as well as to other Euroland and to Non-Euroland countries) of the consequent distortions of trade and other payments would then have to be added to the arguments against Britain's entry.

Furthermore, the benefits of greater certainty and transparency of pricing between Britain and other European countries that would result from Britain entering the euro system would be less than those of membership of the euro area for other European countries, for which transactions with the non-euro world are relatively less significant (and those with the rest of Euroland correspondingly more significant) than they are for Britain. For Britain to maintain as much exchange rate stability as possible, it would be necessary for its currency to be

system obviously this means that Britain's currency also appreciates relative to non-euro currencies, whereas if it remains outside the euro system it remains fixed against the non-euro currencies. Greater fixity on the euro therefore *means* greater flexibility/volatility as against the non-euro world.

⁵ This may be seen from the table in Britain's balance of payments publication ('the Pink Book') up to the year 1996 (the relevant table not having been published for later years) which gives details of those capital account transactions with the other EU countries that have been identified, together with the table for total capital account transactions with the world as a whole.

⁶ It has been suggested (Christopher Huhne, M.E.P., in letter to *The Times*, 28 Mar 2000) that fixity of the exchange rate is relevant only to trade transactions (from the viewpoint of exchange rate certainty and stability). But it is surely just as relevant to be able to compare across countries returns from property including the returns on all financial assets. Exchange rate certainty is also at least a convenience for transfers such as pensions; a resident in one country drawing a pension or other income from another country benefits from knowing what this will bring in the country of residence.

fixed neither on the euro, nor on some average of non-euro currencies, but on some average of all external currencies (as its transactions with non-euro countries are similar in order of magnitude to those with euro countries).⁷

The greater fluctuations of Britain's currency relative to Non-Euroland currencies that would result if Britain entered the euro system would, then, carry real costs to Britain in terms of the loss of certainty about the exchange rate and the loss of transparency of pricing (for capital assets as well as goods and services) with Non-Euroland that would have to be set against any benefits to Britain of increases in certainty and transparency on transactions with Euroland. Furthermore, if one accepts the dominant importance of capital flows over trade flows in such analyses (which Buiter argues), and if fixing the exchange rate helps to reduce distorting and fundamentally unnecessary capital flows (resulting from over-adjustment, bandwagon effects, raids by large hedge funds etc.), there seems to be no presumption that Britain should fix its exchange rate on Euroland. Indeed, the apparent predominance of Britain's capital account transactions with non-euro countries over those with euro countries would argue against increasing the volatility of sterling against non-euro currencies by fixing on the euro.

Moreover, from the global viewpoint, there would also be a corresponding loss to Non-Euroland countries on their transactions with Britain from the loss of certainty and transparency resulting from the greater volatility of Britain's currency against their currencies, as well as from whatever distortions to their trade and living standards might result from Britain entering the euro system.

In any event, as Buiter argues elsewhere (1999 d), it is not the relative importance of transactions with the rest of the proposed currency area that matters most in optimal currency area analysis of the (Mundell) traditional type, but the extent to which real shocks (and the reaction to them) are common to the fixing country and the rest of the currency area. It is thus not merely a question of whether the real shocks affecting Britain are similar to those affecting the Euroland countries. For the real shocks affecting Britain are at least as likely to be common to both Britain and the two largest industrialised economies (the US and Japan), which are outside Euroland, as to Britain and Western Europe.

Take for example the important contemporary real shock of an OPEC-induced rise (or fall) in oil prices. As Britain is not only an important oil importer but also a producer of some

⁷ Since writing this I have found some of these points being made by a writer in *The Times* (Bootle, 2000). He points out that France, Italy and Germany do some 60% of their overall business (current and capital) with other euro countries, whereas Britain does less than half of its transactions (capital and current together) with the euro area.

significance and a net exporter of oil, this would clearly have a very different effect upon Britain to that which it has on Euroland (taken as a whole), which is not relatively such a significant producer of crude petroleum and gas. In this respect Britain has more in common with the US, Canada and Australia than with Euroland as a whole (though much in common with the Netherlands –as well as with Norway (a non-euro European country), which are also oil or gas producers.

Furthermore, as the UK treasury analysis (1997) of these issues has pointed out, Britain's cyclical fluctuations are more closely related to those in the US than with those in France or Germany (the two largest economies of the euro area.)

Presumably Buiter's reply to the above argument that sterling might more reasonably be fixed to non-euro currencies than on the euro (both on capital account grounds and on the grounds of the alleged similarity of the effects on Britain and some principal non-euro countries of some external shocks) would be that Britain needs to be part of an area with a central bank upon which it would have influence, and that the European central bank is the only possibility of this on offer. But whether Britain's influence in the ECB would be adequate to ensure due attention being paid to Britain's interests, one may reasonably doubt.

Moreover, Britain's interests in the matter of monetary policy appear of late to have been strongly opposed to those of most of the main members of Euroland, with Britain operating at boom levels and the principal euro countries still suffering high unemployment. Even if Britain implements its intention of not joining the euro until the macro state of the UK economy 'converges' with that of Euroland (and even if one could assume that that state of affairs would continue), one would need to ask whether it had by then converged *to a greater extent* with Euroland than with the non-euro world before this would constitute a strengthening of the argument for Britain to enter the euro.

In short, arguments for and against Britain entering the euro system need constantly to be set against the obverse of those arguments relating to Britain's position vis-à-vis the non-euro world. Yet this appears to be seldom or never done when the case for and against Britain's entry to the euro is being discussed.

In considering whether Canada should enter a currency union with the USA, Buiter (1999 d) favours such a course only if Canada had an influence on Fed policy by becoming in effect another region of the Federal Reserve system. But, one might doubt whether such membership for Canada in the Fed system would have much influence on Fed policy. Otherwise, Buiter takes the view that the real shocks to which Canada is subject are

sufficiently different from those that face the US (as a whole) to justify Canada in retaining control of its own monetary and exchange rate policy. He clearly gives this consideration greater weight in Canada's case than fixing the Canadian exchange rate against the US dollar with the objective of minimising unproductive capital flows. It is thus somewhat perplexing that he comes down on the other side of the argument when he discusses Britain and the euro. His analysis of Canada is, however, of some interest when considering exchange rate policy for a country such as Australia, which one could consider to be likely to face very different real shocks from either the US or Euroland. It is to exchange rate policy for countries outside Europe and North America that we now turn.

Section 3

Some Other Exchange Rate Issues

It has at times been suggested in the light of the Asian crisis that one or other of the two extremes of a freely floating rate or an absolutely fixed rate may be desirable for countries on the periphery of the world economy – including most of Asia (and presumably, some would argue, also Latin America, and perhaps Oceania.), but that intermediate arrangements are less likely to be appropriate.⁸ But it seems intuitively improbable that intermediate arrangements would never be appropriate. It has, for example, been pointed out (McKinnon and Pill, 1999) that an exchange rate fix that is consistent with the country's purchasing power parity vis-à-vis the US dollar (with a consequently floating nominal rate) may be a form of 'fix' that will discourage large speculative flows of capital – by being more likely to maintain the confidence of external investors than either an absolutely fixed nominal parity or a freely floating rate. But there are many other influences on a country's (equilibrium) exchange rate apart from its price level relative to that of the US. One might mention changes in its terms of trade and in capital flows unrelated to relative price levels; one might also point out that (a change in) the price level of the rest of the world as a whole would be more relevant than that of the US alone – which may well be a very different matter.

But there is a case for a small open economy that wishes to maintain the confidence of external investors to commit itself to fixing its exchange rate in some sense, as a means of maintaining or establishing financial credibility with the world as a whole. In particular, this may reduce the risk of its currency being set upon by large hedge funds, forcing it up or down in defiance of any fundamental factors.

⁸ For example, Stanley Fischer, the then Deputy Managing Director of the IMF, suggested (in a speech in Singapore late in 1999) that this was true for Asian countries. See also Meltzer (2000), Chapter 2. It is relevant that some of the Asian countries who abandoned exchange rate fixity after the 1997-9 crisis had

On the other hand, to forgo the possibility of (real) exchange rate changes (where appropriate) merely for this purpose would appear to be foolhardy. If some indicator of financial credibility is desired, some form of floating exchange rate *coupled with the adoption of an inflation target* by the central bank of that country (for example Chile, and Australia in recent years) might succeed at least as well as the adoption of an exchange rate target.

It is not at all clear what is meant by a fixed exchange rate in a world where major currencies are fluctuating relative to one another. Fixity on one of them means greater flexibility in terms of the others, and may generally mean greater flexibility in relation to the world as a whole. In any event, even if some (nominal) fixed exchange rate commitment to a one other currency is accepted, it is by no means obvious that it should be in terms of the US dollar (which is what McKinnon and Pill have in mind). Another major currency may be at least as relevant as the US dollar from the viewpoint of giving confidence to investors. The level of international borrowing in terms of euros recently suggests that it might be as important to fix on that currency as on the US dollar (for some countries at any rate). More probably, some form of weighted average of currencies might be an appropriate 'anchor'. The IMF's SDR, being a weighted average of member currencies might well be worth considering from this point of view. Trade-weighted averages of currencies for a particular country are deficient as not taking due account of capital and invisible items, and as not generally reflecting the relative importance of different external currencies used in settling its international transactions.⁹ Moreover, if the aim is to maintain confidence in a currency, this is more likely to be achieved by fixing in terms of a known currency unit such as the SDR (the value of which is determined internationally). In any event, if the purpose is to maintain external confidence in a currency, this is more likely to be achieved by fixing on a unit that is determined internationally than a trade-weighted average compiled for that country alone by its own authority. If all countries fixed, or at least reported, their exchange rate in terms of the SDR unit, comparisons between their fluctuations would be simplified, as there would be a single measuring rod with which to do so. Fluctuations in terms of a single currency, such as the US dollar, share that advantage; but have the disadvantage that they often reflect movements in the US dollar relative to other currencies, rather than fluctuations in the individual non-US-dollar currency.

Some countries have taken the approach of fixing their exchange rate on another currency to the point of entering into some form of currency union with it, or even the use of the other currency in their domestic transactions as Argentina has done, and as is proposed for

by 2000 started to add to some extent to their reserves, as a cushion against possible future withdrawal of capital or fall in other external receipts, rather than maintain a completely free float.

⁹ They are, in any event, just index numbers, showing changes over a period, and are not currency units

Ecuador. (This is known as 'dollarisation' when the currency adopted is the US dollar; and the term 'euro-isation' has been used for adoption of the euro by a non-euro currency.) One can understand that when confidence in a currency has completely broken down, some such extreme solution may be desirable. But when a small country fixes on the US dollar, say, it must expect that many influences that will cause the US dollar to fluctuate relative to the rest of the world will not normally also be appropriate for bringing about the same exchange rate alteration (relative to the other currencies of the world) for the 'fixing' country. One financial commentator (David Hale) has suggested that it might be more logical for Argentina to fix on the currency of another largely commodity-exporting country (provided that it was one with a reputation for avoiding serious inflation) such as Australia, rather than on the US dollar. For the influences on the terms of trade of Australia would be more similar to those affecting a country such as Argentina than would the influences that change the relative rate of the US dollar on the rest of the world. In any case, a small country fixing on a large one – or, indeed, Argentina fixing on the Australian dollar – would not be able to assume that the central bank of the other country would take account of the interests of the fixing country in deciding its monetary policy. (But if the sole purpose of the dollarisation is to increase the confidence of external investors in the Argentine currency one can understand that fixing on a major currency such as the US dollar may be the most appropriate solution – if it can be done without consequent damage to the Argentine economy.)

A different situation, from this point of view, would arise if the currency union consisted of two or more broadly similar countries that entered a union by mutual consent, at least where they already had close economic relations in other respects. Australia and New Zealand would be one obvious example.

Some New Zealand businessmen appear to favour such a currency union for the same reason that some British businessmen favour Britain entering the euro: in each case they misguidedly confuse fixing the exchange rate on one external currency with a genuine fixing of the exchange rate (on the outside world as a whole). But in New Zealand's case there is far less excuse for this confusion, as the relative importance of New Zealand's transactions with Australia is far less than that of Britain with Euroland. The relative size of the transactions of Australia and New Zealand with each other is not high enough for this to be a persuasive ground for advocating a common monetary union.

A currency union between Australia and New Zealand would presumably require the setting up of a single central bank for the union, or at least such a close cooperation between the central banks of the two countries that it would amount effectively to a single central bank with a common monetary policy.

It is true that some of the shocks to which Australia and New Zealand are subject would be common to both of them, though the much greater importance of minerals to Australia than to New Zealand would reduce the force of this consideration. Some recent research by economists in the Reserve Bank of New Zealand (McCaw and McDermott (2000), p.40) suggests that in the recent past no more than some 70% of New Zealand's cyclical fluctuations have been common to both New Zealand and Australia. It seems unlikely that New Zealand would benefit by losing the freedom to operate its own monetary policy; and Australia would presumably be reluctant to abrogate some part of its freedom to make its own choices about monetary policy. It is unlikely that the establishment of such union would have a clearly favourable – or unfavourable – effect on world confidence in those currencies.

Section 4

Monetary and Fiscal Policy

For one reason or another, monetary policy is not likely to be freely available to have major effects on employment or output (at any rate, beyond the short run). This is clearly so if it is mainly directed at keeping inflation at an appropriate rate, or if it is mainly directed at targeting an exchange rate. But it may also be so in any case if the degree of nominal price rigidity is not such as to make the real exchange rate move when monetary policy contracts or expands, except perhaps in the short run. Moreover, large flows of speculative capital may also impair the operation of monetary policy, operating as it must largely through the exchange rate. Furthermore, if inflation is kept very low, there may be problems of the type Japan has experienced with nominal interest rates being very low or virtually zero, so that real interest rates cannot be brought low enough to use monetary policy in an expansionary direction. This makes it especially important to ensure that fiscal measures are used appropriately to keep as close to full employment as possible, and to use the mix of taxes and outlays that does this with as little (or as much – as in Japan at present) upward effect on inflation as is appropriate.¹⁰ Decisions about the exchange rate regime that a country will follow is thus to some considerable extent to be integrated with its decisions about how it intends to use its monetary and fiscal policies.

If a country feels that it can sufficiently influence its real exchange rate to have real effects on its current account and its level of output and employment through monetary policy, it will naturally be reluctant to give up the use of the exchange rate instrument. But if it feels that the risks of external forces operating through capital flows will so greatly impair its use of the exchange rate instrument as to make it hard to apply it to influencing real

¹⁰ These issues are discussed in Perkins (1997) and (2000).

macroeconomic variables, it may choose instead to give up the freedom to use it for these purposes, and to attempt to establish international confidence in its currency by some form of fixing – perhaps to one external currency or to an average of them (preferably the SDR unit).

Section 5

Conclusions

Looking a long way ahead, one might argue that the best international monetary arrangements for the world would be to move towards a single currency, supported by a world central bank. Presumably there might still be individual fiscal policies for different countries – at least up to a point – so there would not necessarily have to be a world government. But could the benefits of a single currency be to some extent achieved without this happening; and would there be intermediate steps along the way?

The setting up of the euro system – and its likely expansion – means that there will be a large number of countries operating a fixed exchange rate system. But this is only a fixed rate system in the limited sense that members fix their rates as against each other, and that some non-members may well (as Estonia does at present) fix their exchange rate on the euro without being members. The number of countries fixing against the US dollar, or even adopting full dollarisation, may be expected to increase. The two basic exchange rate issues are therefore the following:

(1) What is to be the exchange rate relationship between the euro bloc and the dollar bloc? and

(2) What are to be the exchange rate arrangements of countries such as Japan and Australia (for example), which are not particularly likely to want to fix their currencies on either the US dollar or the euro?

On the first question, one might expect that at present the European central bank will pursue a policy of benign neglect towards the euro's exchange rate against the US dollar, though if and when the euro becomes extensively used as an international currency outside Europe that attitude may well change. There is, in any event, likely to be a problem of large-scale movements of capital between Europe and North America as a result of having two more or less equal international financial centres. That situation could well lead to some degree of exchange rate coordination between the central banks of those two areas, in order to minimise such hot money flows. This is the more likely if these two main areas find that the use of monetary policy to affect the real targets of employment and output is unreliable, especially in the long run (as Buiter suggests is true for Britain). For the use of

monetary policy to target the exchange rate would then be more defensible. If some sort of fixity between the dollar and the euro comes about, one might expect a large number of outside countries to adhere to such an arrangement, as they would no longer need to choose one of those two currencies when their economic and financial interests are spread between them.

But in the interim, what should non-euro, non-US dollar countries do about their exchange rate arrangements?

For primary-exporting countries (or ones for which manufactured exports are less important than primary and semi-processed products, by comparison with the US or Euroland) most of the real shocks to which they are likely to be subject (through their terms of trade, in particular) are likely to be more or less the obverse of the real shocks affecting the US or Europe. It is thus not reasonable for them to fix on either the US dollar or the euro, from the point of view of reacting to current account shocks.

One solution is simply to target inflation, and let the exchange rate go where it will. This is a reasonable decision, especially for a country such as Australia.

But, from a different point of view, the alternative of some sort of exchange rate fixing should not be ruled out, if foreign exchange markets appear often to be the playthings of forces that seem at variance with 'fundamentals'. This is especially so if the exchange rates of relatively small countries appear to be the subject of machinations by big funds setting out to force their exchange rate in a particular direction. For in such a situation a floating exchange rate makes it very difficult for a central bank to have predictable effects upon real targets of policy or even upon inflation – so far as monetary policy operates through the exchange rate. Some degree of exchange market intervention to offset some types of speculative capital movements that are clearly not related to changes in fundamental factors may well be desirable, though very difficult to implement wisely. It must be acknowledged, however, that the reserves available to a small country may well be inadequate to offset large capital outflows, even when such action might be thought desirable. Probably, it would be only in concert with other countries aiming to work towards some sort of fixity of exchange rates, and providing the resources to achieve this, that this would become feasible. (*Inflows* of capital can always be offset by adding to the reserves.)

If and when the euro and the US dollar became fairly firmly fixed against each other, it would obviously not matter which of these currencies a non-euro, non-US dollar, currency chose to fix upon. But in the interim, the alternative of fixing on a weighted average of those two currencies, or perhaps of them plus the Japanese yen (and, also sterling, if it stays out

of the euro system) might be worth considering. It would still leave open the possibility of speculative capital flows brought about by changes in the exchange rates between each of these main areas having repercussions upon the fixing country (call it 'Australia'). But it might make it less likely that major overseas funds would set out to force the exchange rate for the Australian dollar up or down.

The main conclusions about the various international monetary issues discussed above, and some of their inter-relationships, are as follows:

- (1) If the IMF is to be used as a lender of last resort when the stability of the system is threatened, it clearly needs to have readily available the resources to act in this capacity. Moreover, if it were to be confined to that role, and not continue to support countries in balance of payments difficulties of a more usual sort, the need for those countries to employ changes in their exchange rates for that purpose will be the greater.
- (2) On the other hand, if exchange rates are thought to be of doubtful efficacy for influencing real variables (output, employment, the current account), it will be more appropriate to focus their use on other objectives - not only on the rate of inflation but partly also on maintaining confidence in currencies that might come under suspicion if their exchange rates were not kept reasonably stable in terms of some external benchmark (such as a weighted average of major currencies or the SDR unit). Alternatively, confidence in the currencies of peripheral countries might also be maintained by using their monetary policies to hold down inflation to a target rate, while letting their exchange rate float (as Chile has done with some success among developing countries, and as several other countries including Australia have in fact been doing also). If monetary policy is directed (mainly or solely) towards any of these objectives, a correspondingly greater burden is placed upon fiscal policy for maintaining a high level of economic activity.
- (3) The fixing of one country's currency on another's, or on an average of major currencies, is clearly not compatible with its using its exchange rate for any other purposes – unless the rest of the currency union is operated in a way that happens to have the desired effects. The entry of Britain into the euro system would raise a number of important issues for the rest of the world, as it would have repercussions for other countries that do not appear to have been raised in the discussion. Moreover, those effects on Britain that would result from the effects on that country's transactions with non-euro countries would be at least as important as (and probably more important than) those associated with Britain's trade and payments with Euroland. The pros and cons of Britain entering the euro system should therefore always be discussed in the context of the effects operating through Britain's transactions with the non-euro world.

- (4) Currency unions between two or more countries that are broadly similar in their economic structure may bring net benefits – though probably only if the relative importance of their transactions with one another is great. But fixed and allegedly unalterable pegs of the currency of a peripheral country upon a major currency are likely eventually to become unstuck. They may for a while serve to restore international confidence in a very weak currency; but they are likely to lead to inappropriate exchange rates where the sort of shocks that affect the fixing country are very different from those that affect the country on which it is fixing. The monetary policy implemented by the major currency country is, moreover, unlikely to take account of the requirements of the fixing country.

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